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FEDERAL COMMUNICATIONS COMMISSION  
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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of	)	
	)	
In the Matter of Petition of WorldCom, Inc.	)	
Pursuant to Section 252(e)(5) of the	)	CC Docket No. 00-218
Communications Act for Preemption	)	
of the Jurisdiction of the Virginia State	)	
Corporation Commission Regarding	)	
Interconnection Disputes with	)	
Verizon Virginia Inc., and for	)	
Expedited Arbitration	)	
	)	
In the Matter of Petition of AT&T	)	
Communications of Virginia, Inc.,	)	CC Docket No. 00-251
Pursuant to Section 252(e)(5) of the	)	
Communications Act for Preemption	)	
of the Jurisdiction of the Virginia State	)	
Corporation Commission Regarding	)	
Interconnection Disputes with	)	
Verizon Virginia Inc., and for	)	
Expedited Arbitration	)	

VERIZON VIRGINIA INC.'S MOTION FOR STAY

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**VERIZON VIRGINIA INC.'S MOTION FOR STAY**

Verizon Virginia Inc. ("Verizon VA") hereby requests that the Commission stay the August 29, 2003, Memorandum Opinion and Order (the "*Order*") and the resulting rates pending review by the full Commission or reform of its TELRIC rules.

**PRELIMINARY STATEMENT AND SUMMARY**

The *Order* should be stayed pending the Commission's consideration of Verizon VA's Application for Review, or reform of its TELRIC rules, in order to avoid the irreparable harm that will occur if the *Order* is allowed to go into effect. At a time when the Commission is trying to reform its rules to eliminate artificial subsidies in order to promote efficient competition, the rates resulting from the *Order* would create new subsidies, enlarge existing ones, and thereby further encourage reliance on a single network, rather than investment in competing facilities. It would be

particularly irrational to implement the *Order* now because it pushes TELRIC to radical new extremes that are inconsistent even with existing rules and that further exacerbate the very flaws in TELRIC that the Commission has identified and is seeking to reform in its pending rulemaking.

In 1999, the Virginia State Corporation Commission set UNE prices in accordance with this Commission's TELRIC rules. In 2002, as part of Verizon VA's section 271 application, those rates were reduced significantly to meet this Commission's standard compared to New York and were found to be TELRIC-compliant. The resulting rates are equal to, and in the case of the so-called UNE-P, *lower* than, the corresponding rates in New York — a state that itself has applied TELRIC aggressively. As a result of that previous reduction, competitors in Virginia already have shifted from their previous reliance on facilities they have deployed themselves and now rely instead on using the UNE-P at subsidized rates.

Nonetheless, the *Order* would slash UNE rates in Virginia yet again. For example, preliminary runs of cost studies show that the *Order* will produce rates for end-office switching that are by far the lowest in effect in any of the 31 jurisdictions where Verizon provides local service and about a third lower than what even AT&T proposed. The residential UNE-P rate in zone 1, where some three-quarters of customers are located, is the *second lowest* in any Verizon jurisdiction for any comparable zone. In fact, using WorldCom's own numbers for minutes of use by its platform customers, the *Order* would produce a UNE-P rate in Virginia that is some six dollars lower than the corresponding rate in New York. The high capacity loop rates — which already benchmark to New York — are cut by as much as fifty percent. And numerous non-recurring rates are either slashed or eliminated.

Under the circumstances presented here, each of the factors considered in determining whether to grant a stay overwhelmingly support issuance of a stay.

As an initial matter, Verizon VA is likely to succeed on the merits of its challenge to the *Order* for three reasons. First, the *Order* prejudices major policy issues now under consideration by the full Commission in the *TELRIC NPRM* and does so in ways that both are inconsistent with existing rules and that will create new subsidy flows in addition to greatly exacerbating those that already exist. For example, the *Order* adopts a radical new flat-rate structure for end-office switching that is contrary to existing Commission precedent, that even AT&T did not support because it does not properly align costs and rates, and that creates new subsidy flows from low usage customers to the high volume customers that CLECs typically target. The *Order* also requires that most non-recurring costs be recovered on a recurring basis, even though that too is contrary to existing rules and would force Verizon VA both to serve as the CLECs' banker and to subsidize any CLECs that fail to retain customers long enough to pay off the loan.

Second, in addition to creating all new subsidy flows, the *Order* would greatly increase existing ones by reducing rates drastically below their current TELRIC-compliant levels based on a series of radical assumptions that likewise are contrary to Commission precedent. To cite just a few examples, the *Order* assumes that almost 90% of all switching equipment can be purchased at new switch discounts of up to 99% off the list price, even while recognizing that no rational manufacturer could possibly offer such discounts if carriers bought predominantly new switches. The *Order* assumes that all fiber-fed loops in all locations use integrated digital loop carrier even though the Commission has found and all parties agreed that no *currently available* technology permits the use of that equipment to unbundle loops. The *Order* sets high capacity loop rates that do not even purport to be based on the costs of providing those loops, but instead are based entirely on unsubstantiated and demonstrably erroneous ratios between basic, two-wire loops and

high capacity loops. And the *Order* adopts a non-recurring cost model that simply assumes away many of the tasks necessary for Verizon VA to process CLEC orders.

Other examples are legion. For example, the *Order* changes inputs that no party challenged, adopts inputs that are substantially more extreme than any party proposed, and, in the case of switching, produces rates lower than any party proposed, and a third lower than what even AT&T proposed. The *Order* reduces switching rates, for example, by adopting a digital port fill factor and calculating the total annual minutes of use based on inputs that no party proposed. Similarly, the *Order* manipulates other inputs to produce what state commissions have condemned as a way to “twice-TELRIC[]” rates or “double count[] the TELRIC” reductions to expenses. And it then goes on to adopt other measures that effectively “triple TELRIC” those expenses.

Third, the Supreme Court has clearly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that specific rates are set. As a result, the Commission is required here both to consider the constitutional adequacy of those rates and to establish a mechanism for Verizon VA to recover any shortfall compared to the constitutional minimum *before* the rates are permitted to take effect. And here, there is simply no question that the rates do not come close to meeting that constitutional minimum.

In addition, the *Order* unquestionably will inflict irreparable harm on both Verizon VA and the public interest, and the balance of equities weighs overwhelmingly in favor of a stay. Verizon VA not only will experience enormous revenue losses as a result of the drastic rate reductions inflicted by the *Order*, but also will suffer the loss of customers and goodwill, which the courts have made clear constitutes irreparable harm warranting a stay. And these losses are not even arguably the result of competition, but instead are the direct result of a rate order that forces Verizon VA to subsidize other carriers.

Moreover, the *Order* also is directly contrary to the public interest. The TELRIC rates currently in effect already are set at levels that, in the words of Chairman Powell, are “subsidized and below costs,”<sup>1/</sup> and that already have caused other carriers to abandon the use of competing facilities in favor of relying on Verizon VA’s network at subsidized rates. Reducing the rates further will only exacerbate that trend, to the detriment of the public interest in promoting efficient facilities-based competition. And this result will not necessarily be confined to Virginia alone: although the *Order* is not binding Commission precedent, the CLECs already have begun pointing to the *Order* as *Commission* authority that other states should follow. A stay of the *Order* pending review would limit this harm, while not hurting the CLECs in any way, since the Commission has already determined that the existing UNE rates are TELRIC-compliant. For all these reasons, the balance of the equities and public interest tilt decisively in favor of granting a stay.

### **BACKGROUND**

In 1999, the Virginia State Corporation Commission (“SCC”) set UNE rates pursuant to the Commission’s TELRIC rules after a lengthy proceeding in which Verizon VA and several CLECs filed numerous rounds of testimony, briefs, and reruns of cost studies. Little more than a year later, the Bureau decided to set new UNE rates as part of this arbitration, notwithstanding that state commissions typically wait at least several years before attempting to reset UNE rates.

While this arbitration was pending, the Commission reviewed all the Virginia UNE rates as part of its evaluation of Verizon’s 271 application for Virginia. As part of the section 271 process, the rates set by the Virginia SCC were substantially reduced in order to comply with this Commission’s established “benchmark” standard compared to New York. Specifically, while the

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<sup>1/</sup> Jeremy Pelofsky, “FCC Chief Denies Leaving, Outlines Media Agenda,” *Star-Ledger*, Aug. 19, 2003.

Virginia loop rates already were *lower* than those in New York on a cost-adjusted basis, Verizon VA's switching rates were reduced by approximately 36 percent so that they benchmarked to the corresponding New York rates. *See* Declaration of Patrick Garzillo ("Garzillo Decl.") ¶ 8 (attached as Ex. A). The result was to reduce the UNE-P rate in Virginia to a level below the corresponding rate in New York, a state where carriers already serve more than 2 million customers using UNE-P. *Id.* The high capacity loop rates likewise benchmarked to the comparable New York rates. *Id.* ¶ 9. The Commission concluded that Verizon's recurring and non-recurring rates in Virginia complied with TELRIC.<sup>2/</sup>

Before rates were reduced during the 271 process, competition in Virginia was focused heavily on use of competitors' own facilities.<sup>3/</sup> That changed dramatically in the wake of those rate reductions. Competitors have since shifted to using UNE-P in lieu of their own facilities. For example, the total number of UNE-P lines has ballooned in less than a year from approximately 49,000 lines to 250,000. Garzillo Decl. ¶ 22. At the same time, facilities-based competition has decreased. For example, while competitors were adding nearly 16,000 lines per month in whole or in part over their own facilities before the rate reduction, the number has since dropped by more than half. *See id.* ¶ 23. While competitors were adding more than 1,500 lines per month using their own switches together with unbundled loops before the rate reduction, they since have been shedding an average of more than 1,800 such lines each month. *See id.* ¶ 24.

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<sup>2/</sup> Memorandum Opinion and Order, *Application by Verizon Virginia Inc., Verizon Long Distance Virginia, Inc., Verizon Enterprise Solutions Virginia Inc., Verizon Global Networks Inc., and Verizon Select Services of Virginia Inc., for Authorization to Provide In-Region, InterLATA Services in Virginia*, 17 FCC Rcd 21880, 21929 ¶ 89 (2002) ("Virginia 271 Order").

<sup>3/</sup> *See, e.g., Virginia 271 Order* at 21882-83 ¶ 3 (noting that, according to Verizon's application "there is proportionately more facilities-based competition in Virginia than in any state that has been granted section 271 authority, at the time those applications were filed" (citing Verizon VA Application at 89, Attach. A, Ex. 3)).



Nevertheless, the *Order* reduces rates further still. While the *Order*'s proposed statewide average loop rate (\$14.43) is marginally higher than the existing rate, it is still more than \$1.00 lower than the equivalent rates in New York. *Garzillo Decl.* ¶ 11. With respect to switching, the *Order* adopts a new and radical flat-rate structure and prescribes the inputs to be used in calculating new rates. The switching rates produced by the *Order* are roughly sixty percent lower than the rates that previously were found to be TELRIC-compliant, are lower than those in effect in any of Verizon's thirty-one jurisdictions, are lower than what WorldCom proposed, and result in the non-loop portion of the UNE-P being about one-third lower than what AT&T proposed. *See id.* ¶ 13. Based on preliminary cost study runs, the resulting UNE-P rate for residential customers in zone 1 appears to be the second lowest for a comparable zone in any of the jurisdictions where Verizon provides service. *Id.* ¶ 14. In addition, the *Order* reduces high capacity loop rates by approximately one-half from the previous TELRIC-compliant levels, and decreases — and in many cases eliminates altogether — the existing non-recurring rates. *Id.* ¶¶ 16, 18.

The *Order* makes these rate changes based on a record in which the hearings concluded more than a year and half ago and the studies were filed more than two years ago. Verizon VA moved almost a year ago to allow all parties an opportunity to supplement and update the record. After the Bureau did not respond, Verizon VA filed a formal Proffer of Supplemental Evidence. The Bureau, however, declined to consider this evidence.

## ARGUMENT

A stay is warranted when the movant demonstrates either a likelihood of success on the merits and a showing of “irreparable injury,” or, alternatively, a “serious” question regarding the merits coupled with a more “substantial” showing regarding the balance of equities.<sup>4/</sup>

Verizon VA meets both standards here. Indeed, a stay is particularly warranted here because the *Order* moves in precisely the opposite direction from the Commission in its *TELRIC NPRM*. In the *NPRM*, the Commission explained that TELRIC embodies a “central internal tension[.]” because it “purports to replicate the conditions of a competitive market by assuming that the latest technology is deployed throughout the hypothetical network, while at the same time assuming that this hypothetical network benefits from the economies of scale associated with serving all of the lines in a study area.” Notice of Proposed Rulemaking, *Review of the Commission’s Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 ¶ 50 (rel. Sept. 15, 2003) (“*TELRIC NPRM*”). The Commission noted that this internal inconsistency “may work to reduce estimates of forward-looking costs below the costs that would actually be found even in an extremely competitive market. It therefore may undermine the incentive for either competitive LECs or incumbent LECs to build new facilities, even when it is efficient for them to do so.”<sup>5/</sup> The Commission further explained that the “excessively hypothetical nature of the TELRIC inquiry” renders it a “black box” that is “difficult to reconcile with our desire that UNE

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<sup>4/</sup> *Washington Metro. Area Transit Comm’n v. Holiday Tours, Inc.*, 559 F.2d 841, 844 (D.C. Cir. 1977); *see also* Memorandum Opinion and Order, *TCI Cablevision of Dallas, Inc.*, 15 FCC Rcd 7379 ¶ 2 (2000) (citations omitted).

<sup>5/</sup> *Id.* ¶ 51; *see also id.* ¶ 3 (“To the extent that the application of our TELRIC pricing rules distorts our intended pricing signals by understating forward-costs, it can thwart one of the central purposes of the Act: the promotion of facilities-based competition.”).

prices send correct economic signals.” *Id.* ¶ 7. As a result, the Commission tentatively concluded that its “TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent’s network.”<sup>6/</sup> *Id.* ¶ 52.

Likewise, in a Policy Paper accompanying the *TELRIC NPRM*, Commission Staff has concluded that TELRIC requires reform in order to ensure appropriate cost recovery. As the paper states, “if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment.”<sup>7/</sup> And this shortfall is substantial: “When investment costs are falling by 11% per year (as is assumed for switching assets in the FCC Synthesis Model), the TELRIC correction factor is approximately 50%. That is, switching prices should be increased by 50% from those suggested by Synthesis Model runs.” *Id.* at 43 (emphasis added).

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<sup>6/</sup> The Commissioners themselves have echoed these conclusions. For example, Chairman Powell has correctly recognized that the TELRIC rules are “subsidized and below costs,” “distort a competitor’s decision whether to invest in new facilities,” and need to be changed to “an approach grounded in the real-world attributes of the incumbent’s network.” *TELRIC NPRM*, Separate Statement of Chairman Powell at 1. Commissioner Martin has explained that the rules need to be adjusted to “more accurately reflect incumbent costs and help spur deployment in new facilities and services.” *TELRIC NPRM*, Separate Statement of Commissioner Martin at 1. Indeed, Commissioner Martin observed that, “the Wireline Competition Bureau’s interpretation of the TELRIC pricing rules in the recent Virginia Arbitration Order may not reflect the direction and spirit of today’s decision” in the *TELRIC NPRM*. *Id.* Commissioner Abernathy has pointed out that the current pricing standard is “excessively hypothetical,” and “sends inappropriate investment signals and produces irrational pricing.” *Id.*, Separate Statement of Commissioner Abernathy at 1. And Commissioner Adelstein has acknowledged that the rules may need to be changed to “more closely account for certain real world factors.” *Id.*, Separate Statement of Commission Adelstein at 1.

<sup>7/</sup> David M. Mandy & William W. Sharkey, “Dynamic Pricing and Investment from Static Proxy Models,” FCC, Office of Strategic Planning and Policy Analysis, OSP Working Paper Series No. 40, at 1 (Sept. 2003); *see also id.* at 1-2 (“Indeed, when investment costs are falling over time and TELRIC price reviews are conducted at intervals shorter than expected asset lives, the firm will earn less than its target rate of return under traditional implementations of TELRIC.”).

Given all of this, it would be inherently arbitrary and capricious to permit rates to go into effect when those rates not only are based on admittedly flawed rules, but consistently are based on extreme approaches that are both inconsistent with existing rules and that inexorably drive rates lower still. This is especially true when the Commission found the existing rates to be TELRIC-compliant less than a year ago, and the *Order* would drive rates substantially below even TELRIC. Implementing the *Order*, at least in its current form, would be irrational and unlawful. Thus, the Commission should simply stay the *Order* until it reforms its TELRIC rules. But even if the Commission were to choose not to wait until its underlying rules are corrected, it should stay the *Order* until it can make the numerous corrections necessary so that the resulting rates are at least as economically rational as the current TELRIC rules permit.

**I. Verizon VA Is Likely To Succeed on the Merits.**

The *Order* is replete with unlawful and flawed decisions that must be reversed on review. As discussed below, on numerous significant inputs and cost issues, the *Order* prejudices important policy questions pending before the Commission and decides them in ways contrary to existing Commission precedent. And it adopts extreme and unsupported assumptions that drive down rates and create new subsidies that will result in substantial underrecovery of costs and deter the development of efficient competition.

Although Verizon VA focuses on only a few particular inputs here, as its accompanying Application for Review makes clear, the *Order*'s errors are by no means confined to these inputs. Instead, on issue after issue, the *Order* makes extreme decisions that are contrary to law and unsupported by the record. Indeed, the *Order* even changes inputs that no party challenged, adopts inputs that are substantially more extreme than any party proposed, and consequently produced rates that are lower than any party proposed. In the case of switching, for example, the *Order* sets the digital port fill factor at the same level as the analog port fill factor, even though *all*

parties agreed that the fill factor for digital ports should be significantly lower than the fill for analog ports. The effect is to lower substantially the costs of switching. Similarly, the *Order* significantly increases the total annual minutes of use over which investment is spread, and therefore reduces switching rates, by radically increasing the number of days that are assumed to experience peak usage in Verizon VA's studies. Yet *no* party challenged this input, and *no* alternative was proposed in the record. Similarly, the *Order* gerrymanders the calculation of annual expenses in a manner that the New York state commission has described as "twice TELRIC-[ing]" or "double counting the TELRIC" reduction.

In these circumstances, Verizon VA is overwhelmingly likely to succeed on the merits.

**A. The *Order* Prejudges Significant Policy Issues that Are Currently Pending Before the Commission.**

The *Order* should be reversed because it improperly decides several important policy issues that the Commission is considering in the *TELRIC NPRM*. While the Commission is undertaking reform of its pricing rules to eliminate artificial subsidies and promote efficient competition, the *Order*'s resolution of these issues is not only inconsistent with existing Commission precedent, but creates new subsidy flows to CLECs that send incorrect economic signals.

***Switching Rate Structure.*** The *Order* adopts the most extreme proposal on the record with respect to the structure of local switching rates and eliminates all minute of use charges for end-office switching. *None* of the thirty-one jurisdictions in which Verizon provides service has imposed this flat-rate structure on Verizon, and even AT&T agreed that it does not properly align with costs. This decision is inconsistent with Commission precedent and prejudices the very question pending in the *TELRIC NPRM* as to whether such a "change[]" in the rate structure

would comply with the Act.<sup>8/</sup> And it would create a whole new set of subsidy flows from low-volume users to high volume users (and the carriers that serve them) at a time when the Commission is trying to eliminate such subsidies.

As an initial matter, a flat-rate switching structure is inconsistent with Commission precedent. As the *Order* recognizes, under existing rules, “incumbent LECs’ rates for interconnection and unbundled elements *must* recover costs in a manner that reflects the way they are incurred.”<sup>9/</sup> As the Commission has consistently recognized, a significant portion of switching costs are usage-sensitive and thus recoverable on a minute of use basis. In the *Local Competition Order*, for example, the Commission set usage-sensitive minute of use proxy rates for the switching UNE.<sup>10/</sup> Similarly, the Commission has repeatedly rejected arguments that all switching costs are non-traffic sensitive and has approved 271 applications in which significant portions of switching costs were recovered through a minute of use component.<sup>11/</sup> And the Commission

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<sup>8/</sup> See *TELRIC NPRM* ¶ 132.

<sup>9/</sup> First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, 15874 ¶ 743 (1996) (“*Local Competition Order*”); *Order* ¶ 458 (recognizing that under existing rules “UNE rates [must] be structured consistently with the manner in which the costs of providing them are incurred”).

<sup>10/</sup> 47 C.F.R. § 51.513(c)(2); see also *Order on Reconsideration, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 13042, 13045 ¶ 6 (1996) (noting that “the unbundled local switching element, as defined in section 251(c)(3), includes . . . the usage-sensitive switching matrix”).

<sup>11/</sup> *Virginia 271 Order*, 17 FCC Rcd at 21948-49 ¶ 121; Memorandum Opinion and Order, *Application by Verizon New England Inc., Verizon Delaware Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization To Provide In-Region, InterLATA Services in New Hampshire and Delaware*, 17 FCC Rcd 18660, 18697-97 ¶ 61 (2002) (“*Delaware/New Hampshire 271 Order*”).

likewise has concluded in the access charge context that switching costs are usage-sensitive “*and so should be priced on a usage-sensitive basis.*”<sup>12/</sup>

Even AT&T did not support a flat-rate structure for end-office switching and agreed that a flat switching rate “does not properly align rates and costs.” Direct Testimony of Robert J. Kirchberger at 15 (July 31, 2001) (“AT&T Ex. 4”). Likewise WorldCom, which proposed this approach, confessed that at least some switching costs vary with usage, and simply argued that a flat-rate would be “easy to administer and audit.”<sup>13/</sup> And the *Order* itself recognizes that some costs are traffic sensitive and “vary with usage,” *see Order* ¶ 473, but concludes that it would be too difficult to structure rates that accurately tracked causation. Yet each of the thirty-one states that have set switching rates for Verizon has done precisely that and set end-office switching rates as a combination of a usage-sensitive minute of use rate and a flat-rate port cost.

In addition to being inconsistent with the Commission’s own precedent, the *Order*’s determination also will create new subsidy flows in addition to those that already exist. Under a flat-rate structure, customers with below-average usage levels will subsidize customers with

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<sup>12/</sup> Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, *Access Charge Reform Price Cap Performance Review for Local Exchange Carriers*, 11 FCC Rcd 21354, 21392 ¶ 73 (1996) (emphasis added) (“The central processing portion of the switch, and many trunk-side ports, are shared local switching facilities because they are used to carry the traffic of several access customers, and so should be priced on a usage-sensitive basis.”) (“*Access Reform NPRM*”); Order Terminating Tariff Investigation, *Iowa Telecomms. Servs., Inc.*, WC Docket No. 03-135, FCC 03-221 ¶ 4 (rel. Sept. 9, 2003) (allowing an access traffic sensitive rate for Iowa Telecom).

<sup>13/</sup> Joint Initial Post Hearing Brief of WorldCom, Inc. and AT&T on Switch Cost Issues at 26 (Jan. 17, 2002); *see also* Direct Testimony of Chuck Goldfarb at 4 (July 31, 2001) (“WorldCom Ex. 5”) (admitting that certain switching resources are designed in anticipation of peak period usage but proposing that they be recovered through a flat rate for administrative reasons).

above-average usage levels<sup>14/</sup> — precisely those customers that CLECs generally target.<sup>15/</sup> The *Order*<sup>4</sup>’s suggestion that Verizon VA had not proven the existence of this subsidy wholly defies common sense. When a product or service is offered at a flat rate, high volume users obviously will benefit more than low volume users since high volume users will not pay more for the greater share of resources they consume. To take a simple example, customers who eat less at an “all-you-can-eat” buffet clearly subsidize customers who eat more.

***Recovery of Non-Recurring Costs.*** The *Order* requires Verizon VA to recover most non-recurring costs through recurring rates. *See Order* ¶ 584. This inappropriately prejudges the same “difficult decision” the Commission is considering in the *TELRIC NPRM* as to whether it should change its own long standing policies and precedent and require incumbent LECs to recover non-recurring costs in recurring rates, and if so, in what circumstances. *TELRIC NPRM* ¶¶ 121-24. And, again, it creates yet another new subsidy flow in addition to those that already exist under existing Commission rules.

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<sup>14/</sup> See Verizon Virginia Inc. Initial Post Hearing Brief on Switching Issues at 20 (Jan. 17, 2002) (“VZ-VA Switching Br.”); Rebuttal Testimony of Harold E. West III at 5 (Aug. 27, 2001) (“VZ-VA Ex. 115”).

<sup>15/</sup> See *Q2 2003 AT&T Earnings Conference Call - Final*, Transcript 072403ag.742, FD (Fair Disclosure) Wire (July 24, 2003) (David Dorman, AT&T Chairman and CEO, noting that “AT&T consumer second quarter results demonstrate continued progress in expanding our product portfolio in new markets to attract and retain high-value customers. As we continue our transition from a stand-alone long distance company to a provider of [a] robust bundle of services, the bulk of our energy is being directed toward this high value segment, which represents a higher priority for us than the overall market share gains.”); *id.* (noting that AT&T is “very, very focused on” the “high-value customer segment.”); Statement of Betsy Bernard, AT&T Consumer Services President and CEO, *Q2 2002 AT&T Earnings Conference Call - Final*, Fair Disclosure Wire, Transcript 072302au.729 (July 23, 2002) (“Once we’ve entered a state, we design and target each offer to high-value customers to further improve the economics of the business.”); Legg Mason, *Telephone Wars: Local Competition Update* at 2 (May 22, 2001) (“The CLEC sales figures reflect larger market share gains than those calculated on the basis of line lost, since the majority of lines lost are of the high-usage commercial type.”).



The Commission has consistently recognized that “LECs should . . . recover through an NRC their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers.”<sup>16/</sup> The Commission specifically found that “[l]oad[ing] the unrecovered non-recurring costs into recurring rates” would be “inconsistent with the policies . . . that favor recovering costs from the cost causer” and “would distort the prices paid by . . . customers.”<sup>17/</sup> Simply put, “LECs should not be forced to underwrite the risk” of CLECs’ entry.<sup>18/</sup>

The *Order* violates these Commission principles. Recovering non-recurring costs through recurring rates requires estimating how long the average customer will take service — an uncertain exercise at best that almost inevitably will create a substantial risk of underrecovery for Verizon VA. The *Order* itself acknowledges this difficulty in another context, finding Verizon VA’s proposal to collect disconnect charges at the time of connection would be “complicated and . . . prone to error” because it would “require[] an assumption as to how long the competitive LEC will retain a customer.” *Order* ¶ 597. In effect, the *Order* requires Verizon VA to act as the

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<sup>16/</sup> Memorandum Opinion and Order, *Interstate Access Tariff Non-Recurring Charges*, 2 FCC Rcd 3498, 3501-02 ¶¶ 32-33 (1987) (“*Non-Recurring Charges Order*”); see also *id.* 3499, 3502 ¶¶ 12, 35; *Local Competition Order* ¶ 743.

<sup>17/</sup> *Non-Recurring Charges Order* at 3499, 3502 ¶¶ 12, 35; Order, *MCI Telecommunications Corp. Application for Review of the Ameritech Operating Companies, Bell Atlantic Telephone Companies, BellSouth Telecommunications Inc., Cincinnati Bell Telephone Company, GTE Service Corporation, the Nynex Telephone Companies, Pacific Bell, Rochester Telephone Corp., Southern New England Telephone Company, Southwestern Bell Telephone Company, the United Telephone and Central Telephone Companies, and US West Communications*, 12 FCC Rcd 16565, 16571 ¶ 12 (1997).

<sup>18/</sup> Second Report and Order, *Local Exchange Carriers’ Rates, Terms, and Conditions for Expanded Interconnection through Physical Collocation for Special Access and Switched Transport*, 12 FCC Rcd 18730, 18750 ¶ 33 (1997).

CLEC's banker, extending credit to the CLEC for immediate cash outlays that Verizon VA will recover, if at all, only through periodic payments over time.

As the Commission itself previously found, the result is to create a new subsidy that flows from "long term" users — here, the ILECs — to "short term" users of the network — here, the CLECs.<sup>19/</sup> In the *Triennial Review Order*, the Commission just recently found that "there is a significant amount of churn . . . among mass market customers." *Id.* ¶ 471. Under the *Order's* rate structure, CLECs would not have to pay a substantial portion of the non-recurring costs associated with the customers they lose as a result of this churn. WorldCom has stated that 50% of its new local customers switch carriers within the first *three* months of signing up for service. *See id.* Moreover, the continued spate of CLEC bankruptcies further increases the risk that Verizon VA will be unable to recover its non-recurring costs through recurring rates; indeed, in the last seven years, 140 CLECs in Verizon's service area have filed for bankruptcy, and more than 50 have gone out of business. This shifting of risks from the CLECs to Verizon VA would, at minimum, require adjustments to the uncollectibles figure and an additional risk premium. The *Order* did not address these issues at all and in fact refused even to consider additional evidence concerning uncollectibles and the appropriate risk premium.

**B. The Order Adopts Extreme and Erroneous Assumptions That Produce Radically Low Rates.**

At the same time that the Commission is considering how to make TELRIC more realistic and ensure that it sends more rational pricing signals, the *Order* adopted a number of extreme hypothetical inputs that produce absurdly low rates — rates that are radically lower than those that the Commission found to be TELRIC-compliant.

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<sup>19/</sup> *Interstate Access Tariff Non-Recurring Charges*, 2 FCC Rcd 3498, 3501-02 ¶¶ 32-33 (1987).

## 1. Switching

Along with the determination to adopt a flat-rate structure for end-office switching, the *Order* assumes a radically low switch discount and bases switch port costs on the assumption that IDLC-GR-303 is used for all fiber-fed lines even though that technology cannot be unbundled. The combined result is to produce switching rates that are sixty percent less than the level the Commission found to be TELRIC-compliant, the lowest of any rate in effect in any of the thirty-one jurisdictions in which Verizon provides service, and that produce non-loop rates that are *one-third* lower than what AT&T proposed (and lower even than what WorldCom proposed as well). And this dramatic reduction produces a residential UNE-P rate in zone 1, where approximately three-quarters of customers are, that is the second-lowest rate in any Verizon jurisdiction for any comparable zone. In fact, using WorldCom's own numbers for minutes of use by its platform customers, the *Order* would produce a UNE-P rate in Virginia that is some six dollars lower than the corresponding rate in New York.

**Switch Discount.** The *Order* adopted a switch discount under which more than 90% of Verizon VA's vendor switching equipment is assumed to have been purchased at so-called "new switch" discounts, and those discounts are as high as 99% off the list price. This outcome is inconsistent with the Commission's guidance on the appropriate switch discount assumption under TELRIC, makes no sense, and is contradicted by the *Order*'s own conclusions.

The *Order* itself recognizes that no manufacturer would offer such high new switch discounts if carriers bought most switching capacity at new switch rates. As it expressly observed, "[i]f carriers did not typically grow their switches over time, it is unlikely that switch vendors would provide relatively large discounts on the initial switch investment." *Order* ¶ 385 & n.1014. Manufacturers make such discounts available because "efficient carriers do add to or grow their switches over time," *Order* ¶ 386, and thus much of switching capacity is purchased at "growth

discounts,” which typically are much lower than the new switch discounts. *See, e.g.*, Tr. at 2953-54 (Shelanski); VZ-VA Switching Br. at 9. As the D.C. Circuit has recognized, manufacturers offer substantial new switch discounts because that “locks in” carriers to purchase more expensive additions to that new switch.<sup>20/</sup> If carriers bought 90% new switches, rational switch vendors could not possibly offer extremely high discounts for new switches and still recover their costs. As the Commission explained to the D.C. Circuit and the court ultimately agreed, in “an ideal world where vendors can’t lock telephone companies into their product” with the expectation of additional growth purchases, such deep new switch discounts would not exist.<sup>21/</sup>

Thus, if carriers used primarily new switches to deploy switching capacity, as the *Order* assumes, the current discounts unquestionably do not reflect the prices that would prevail. Under such a scenario, vendors inevitably would *increase* their prices for new switches due to higher demand. *See Verizon Virginia Inc. Recurring Cost Panel Surrebuttal Testimony* at 168-69 (Sept. 21, 2001) (“VZ-VA Ex. 122”); Tr. at 2953-54 (Shelanski). In order to remain economically viable, manufacturers must still recover the same average per-line revenue even if the mix of new and growth purchases were different. This might be thought of as a form of “life cycle” cost for switching capacity, where the life-cycle price is the aggregate price that the switch manufacturer will try to recoup over the entire range of components it expects incumbents to purchase. The *Order*, while giving lip service to this theory, completely ignores it in adopting the switch discount

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<sup>20/</sup> *See AT&T Corp. v. FCC*, 220 F.3d 607, 618 (D.C. Cir. 2000) (agreeing with the Commission’s position that “growth additions to existing switches cost more than new switches *only because* vendors offer substantial new switch discounts in order to make telephone companies dependent on the vendors’ technology to update the switches”) (emphasis added).

<sup>21/</sup> Oral Argument Tr. at 35, *AT&T Corp. v. FCC*, 220 F.3d 607 (D.C. Cir. 2000) (argued Apr. 24, 2000); *AT&T Corp.*, 220 F.3d at 618.

assumption. This “[i]nternally inconsistent reasoning . . . is not entitled to any deference by the courts and is inherently arbitrary and capricious.”<sup>22/</sup>

Instead, the best measure of what manufacturers would offer in the way of a switch discount is Verizon VA’s recent purchase prices and current contracts, which reflect the mix of new and “growth” switches Verizon VA expects to purchase going forward to add capacity to its network. These discounts reflect the revenues that Verizon VA’s switch vendors expect to recover over the range of switch purchases they expect Verizon VA to make. And, as noted above, if Verizon VA were expected to buy more new switches and less growth equipment, then manufacturers would necessarily use a different pricing structure to recover more of their costs from new switches. Thus, the average cost of switching capacity would not change in a hypothetical TELRIC world. And ignoring this simple fact was a major reason the *Order* was able to ratchet down rates to such absurdly low levels.

**IDLC-GR-303 Switch Ports.** The *Order* significantly understates Verizon VA’s switching costs by assuming that *all* fiber-fed loops use IDLC and that therefore switches use all IDLC-GR-303 digital line ports. This conclusion is wrong because it ignores the fact that IDLC-GR-303 cannot be used to unbundle stand-alone loops, and that the network therefore must contain UDLC. The *Order*’s determination is thus flatly inconsistent with the Commission’s rule that TELRIC rates must be based only on “currently available” technology, and irrationally assumes that unbundled loops will be provided using a technology that is not capable of being used for unbundling. Indeed, the Commission explicitly has stated in the *Virginia 271 Order* that “it is not technically feasible to unbundle an IDLC loop.” *Virginia 271 Order* ¶ 148.

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<sup>22/</sup> *Louisiana Fed. Land Bank Ass’n v. Farm Credit Admin.*, 180 F. Supp. 2d 47, 57 (D.D.C. 2001), *rev’d on other grounds*, 336 F.3d 1075 (D.C. Cir. 2003).

The evidence before the Bureau also showed that IDLC-GR-303 cannot currently be used to unbundle stand-alone loops in a multi-carrier environment.<sup>23/</sup> In fact, as Verizon VA's proffered evidence demonstrated, even AT&T has conceded that GR-303-based unbundling is not possible.<sup>24/</sup> The record overwhelmingly showed that no carrier uses IDLC-GR-303 to unbundle loops and that no equipment is sold that provides that capability.<sup>25/</sup> Therefore, the *Order* irrationally assumes that all fiber-fed loops are unbundled using a technology that is not even capable of performing that function. And it does so notwithstanding the fact that Verizon VA has not deployed the assumed technology in Virginia and does not plan to do so.

In addition, because the *Order* assumes the use of a technology that is not currently available to provision unbundled loops, it is fundamentally inconsistent with the Commission's rules requiring that any technology assumed for TELRIC-purposes must be "currently available."

47 C.F.R. § 51.505(b)(1). The Supreme Court has pointed to this rule as one of the chief

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<sup>23/</sup> Verizon Virginia Inc. Initial Post Hearing Brief at 90 (Dec. 21, 2001) ("VZ-VA Initial Br."); VZ-VA Ex. 122 at 77-80; Tr. at 4081-85, 4164-65 (Gansert).

<sup>24/</sup> See Letter from Joan Marsh, Director, Federal Government Affairs, AT&T Corp., to Marlene Dortch, Secretary, FCC, CC Docket Nos. 01-338, 96-98, and 98-147, at 3 (filed Dec. 4, 2002) (noting that "[t]here are provisioning, alarm reporting, and testing issues that have not yet been worked out for using GR-303 in a multi-carrier environment," and "other operational concerns must be addressed before the deployment of any solution whose underlying architecture and technology is premised on GR-303 DLCs"); Declaration of Irwin Gerszberg on Behalf of AT&T Corp. in CC Docket Nos. 01-338, 96-98, and 98-147 (filed Apr. 4, 2002), ¶ 14 (emphasis added) (observing that "the available processes for *removing* the customer's loop from the DLC . . . can be time consuming, entail significant costs . . . and may also cause the customer to receive a degraded level of service"); AT&T New York ELP Ex Parte at 4 (May 2002).

<sup>25/</sup> See Verizon Virginia Inc. Initial Post Hearing Brief at 90-92 (Dec. 21, 2001) ("VZ-VA Initial Br."); Tr. at 4583-85 (Gansert); VZ-VA Ex. 124, Attach. A. The record showed that even Telcordia, the author of the GR-303 protocol, recognized that various security, error protection, and OSS concerns must be resolved in order for GR-303 to be capable of unbundling standalone loops. VZ-VA Ex. 157 at 1 (Telcordia's website notes that "*new requirements* are needed to support alternative distribution technologies . . . as well as new services and applications (e.g., . . . *local loop unbundling*).") (emphasis added); see also Tr. at 4585-86 (Gansert).

constraints on TELRIC.<sup>26/</sup> The *Order* seeks to defend its 100% IDLC assumption on the ground that, even if GR-303 unbundling capabilities are not currently available, the future development of such capabilities may be “technically feasible,” *Order* ¶ 315, because the problems with such unbundling are “eminently solvable,” *id.* ¶ 319. But *technical feasibility* is not the relevant test: as the Commission found in *Triennial Review*, any technology assumed for TELRIC purposes must be actually deployed and capable of performing the relevant function in at least *some* carrier’s network, and may not be technology that theoretically “may be available in the future.” *Triennial Review Order* ¶ 670 n.2020. Indeed, the *Order* recognizes elsewhere that TELRIC disallows “overly optimistic assumption[s] about the capabilities of currently available technolog[ies].” *Order* ¶ 569. Its failure to comply with the “currently available” limitation here is reversible error. *See* 47 C.F.R. § 1.115(b)(2)(i).

The *Order* also points to two pieces of evidence to support its 100% IDLC-GR-303 assumption, but neither shows that IDLC-GR-303 is currently available. First, it relies on a few isolated quotes in the non-cost arbitration record that it contended demonstrate that IDLC-GR-303 unbundling is possible. *See Order* ¶ 315 nn.817-18 (citing Non-Cost Testimony at 276-78, 292-93 (John White)). But those quotes actually illustrate that an IDLC-fed loop *cannot* be unbundled: the testimony refers to the fact that where a loop is served by IDLC, it is technically feasible for Verizon VA to build an entirely new, *unintegrated* DLC system, from scratch, upon receiving a *bona fide* request from a CLEC for an unbundled loop. Indeed, the non-cost arbitration order

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<sup>26/</sup> *Verizon Communications Inc v. FCC*, 535 U.S. 467, 506 & n.22 (2002) (noting that under TELRIC, “the marginal cost of a most-efficient element that an entrant alone has built and uses would not set a new pricing standard until it became available to competitors”).

seemed to recognize this, noting that unbundling a loop served by IDLC would require movement to a different facility.<sup>27/</sup>

The *Order* also points to the fact that Verizon VA's network in the former-GTE region uses IDLC-GR-303 as justification for assuming the network is equipped 100% with such technology. *Order* ¶ 317. But this has no relevance to the question whether IDLC can be used to provision standalone unbundled loops to CLECs: no party denies the *existence* of IDLC-GR-303 or suggests it is not deployed anywhere. The point is, however, that existing GR-303 technology does not have loop unbundling capabilities.

## **2. High Capacity Loop Rates**

The *Order's* methodology for setting DS3 and DS1 loop rates is wrong for two reasons. First, it is not based on the costs of providing high capacity loops at all, and does not even purport to be. Second, it starts with a modified version of the universal service "Synthesis Model," which the Commission and the D.C. Circuit have recognized should not be used to set UNE rates at all, and which *all* parties recognize is particularly incapable of measuring high capacity loop rates. The *Order* should instead have used Verizon VA's models, which produce cost-based high capacity loop rates, and one which the *Order* itself found determines costs appropriately for closely related network elements (namely, high capacity transport).

To calculate DS1 and DS3 loop rates, the *Order* does not even try to measure the actual costs of providing those loops. Instead, it adopts rates out of thin air by applying ratios proposed by AT&T/WorldCom to the 2-wire loop rates produced by the modified version of the universal

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<sup>27/</sup> Memorandum Opinion and Order, *Petition of WorldCom, Inc. et al, Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 17 FCC Rcd 27039, 27274 ¶ 478 (2002).



service model. These “ratios” do not account for any actual cost relationships between 2-wire and high capacity loop rates. Indeed, the *Order* does not even purport to understand the basis for the ratios, finding them “lack[ing] [in] thoroughness and clarity,” *Order* ¶ 341, and acknowledging that it was “unable . . . to identify the starting point for the AT&T/WorldCom calculations.” *Order* ¶ 341 & n.888. In fact, there is no fixed cost relationship among 2-wire and high capacity loops. While basic 2-wire loops are provided over facilities with large amounts of copper cable, DS1 and DS3 loops are much more likely to be provided over fiber facilities. Indeed, DS3 loops are provided using the same type of high capacity fiber optic systems used in the interoffice transport network and *cannot* be provided over the copper facilities or digital loop carrier systems used to provide basic 2-wire loops. Moreover, the relationship in costs between DS1 and basic 2-wire loops may vary substantially from region to region based on a number of factors. For example, the equipment used for DS1 loops will depend on the demand characteristics in any given area, and thus may be very different depending on whether a particular state is predominantly urban, suburban, or rural.

Not surprisingly, then, a review of the basic 2-wire, DS1, and DS3 loop rates ordered in Verizon’s largest states where it has received section 271 authorizations do not reflect any set cost relationship among these three types of loops. Instead, the ratio of DS1 loop rates to basic 2-wire loop rates and the ratio of DS3 loop rates to DS1 loop rates vary dramatically among these states. *See Garzillo Decl.* ¶¶ 20-21.

The *Order*’s approach is particularly inappropriate because it begins with rates produced by the modified version of the universal service Synthesis Model, which the Commission

explicitly has found “should not be relied upon to set rates for UNEs.”<sup>28/</sup> The Commission further has observed that it “has never used the [universal service] cost model to determine rates for a particular element, nor was it designed to perform such a task.”<sup>29/</sup> And the Commission has noted “the critical difference between using the Synthesis Model (or any other model) to determine absolute UNE costs, and using it for the limited purpose of comparing cost differences between the states. In section 271 proceedings, the Commission uses the Synthesis Model only for the latter purpose; we have not used the model to compare UNE rates set by a commission to costs produced by the model. Indeed, the Commission has repeatedly cautioned against using the

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<sup>28/</sup> Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, 16 FCC Rcd 6237, 6277-78 ¶ 84 (2001), modified, *Sprint Communications Co. v. FCC*, 274 F.3d 549 (D.C. Cir. 2001) (“*Kansas/Oklahoma 271 Order*”).

<sup>29/</sup> Memorandum Opinion and Order, *Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., For Authorization to Provide In-Region, InterLATA Services in Massachusetts*, 16 FCC Rcd 8988, 9003-04 ¶ 32 (2001) (“*Massachusetts 271 Order*”); Memorandum Opinion and Order, *Application by Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in Maine*, 17 FCC Rcd 11659, 11675 ¶ 28 n.107 (2002) (“*Maine 271 Order*”) (“[T]he Commission has generally cautioned . . . that the Synthesis Model was developed for the purpose of determining high cost support and may not be appropriate for other purposes.”); *WorldCom v. FCC*, 308 F.3d 1, 9 (D.C. Cir. 2002) (upholding FCC’s rejection of WorldCom’s claim that rates are too high because they differ from the “data collected by the Commission for the purposes of implementing its duties as to the Universal Service Fund - information that the FCC insists is unreliable for the determination of UNE rates”); Ninth Report and Order and Eighteenth Order on Reconsideration, *Federal-State Joint Board on Universal Service*, 14 FCC Rcd 20432, 20455-56 ¶ 41 (1999) (“[T]he federal cost model was developed for the purpose of determining federal universal service support, and that it may not be appropriate to use nationwide values for other purposes, such as determining prices for unbundled network elements.”); Tenth Report and Order, *Federal-State Joint Board on Universal Service*, 14 FCC Rcd 20156, 20172 ¶ 32 (1999) (same).

Synthesis Model to set rates.”<sup>30/</sup> The Commission just recently reiterated this point in the *TELRIC NPRM*, explaining that it did not intend for the universal service model “to provide *any* systematic guidance to states in the area of TELRIC rate-setting.” *TELRIC NPRM* ¶ 46 (emphasis added).

And it is particularly inappropriate to use the modified universal service model as the starting point for high capacity loop rates given that *all* parties agree, and the *Order* itself acknowledges, that the model itself cannot produce high capacity loop rates. *See, e.g.*, Tr. at 4485 (AT&T/WorldCom witness Pitkin) (“There is no question that [DS1 and DS3] services are not explicitly modeled in the network.”); *Order* ¶ 332.

In all other cases where the MSM cannot produce rates, the *Order* concedes that the appropriate response was to rely on Verizon VA’s studies. *Order* ¶ 554 (NID, subloops, entrance facilities, and others). There was no valid reason not to do the same here. Verizon VA submitted models that produced cost-based rates for high capacity loops. In fact, the DS3 rates proposed by Verizon VA are based on a model the *Order* specifically finds to comply with TELRIC and that the *Order* adopts for purposes of setting transport rates. *See Order* ¶ 503. And the loop cost model Verizon VA used to set DS1 rates has been used by Verizon to set loop rates that the Commission found TELRIC-compliant in the 271 proceedings for New Jersey, Delaware, Virginia, and Pennsylvania.

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<sup>30/</sup> Memorandum Opinion and Order, *Application by Verizon Maryland Inc., Verizon Washington, D.C. Inc., Verizon West Virginia Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services, Inc., for Authorization To Provide In-Region, InterLATA Services in Maryland, Washington, D.C., and West Virginia*, 2003 FCC LEXIS 1486 ¶ 89 (2003) (“*Maryland/Washington, D.C./West Virginia 271 Order*”)

### 3. Non-Recurring Costs

The *Order* slashes non-recurring rates by adopting AT&T/WorldCom's model even though that model is patently inadequate and is based on extreme hypothetical assumptions that do not permit Verizon VA to recover the out-of-pocket costs it incurs to provide UNEs. The *Order* thus is inconsistent with the Commission's long-standing recognition that "LECs should . . . recover . . . their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers." *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33; *see also id.* 3499, 3502 ¶¶ 12, 35. As the Commission has explained, non-recurring tasks "clearly generate[] costs for the LECs. To the extent that customers seek to avoid such costs, they seek a subsidy. The creation of such a subsidy would be at odds with our stated goal of achieving cost-based . . . rates." Memorandum Opinion and Order, *Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket No. 85-166, 1986 FCC LEXIS 4103, at \*13 (Jan. 24, 1986).

The Commission has further made clear that if an incumbent must perform work to provide interconnection or access to network elements, it must be compensated for the costs of that work. As the Commission has stated, a CLEC is "required to bear the cost" of "modifications to incumbent LEC facilities to the extent necessary to accommodate interconnection or access to network elements." *Local Competition Order* ¶¶ 198-99. Conversely, the Commission has expressly rejected claims that some or all of those costs can be assumed away on the theory that they would not have to be incurred in some different hypothetical network. Thus, for example, it has rejected arguments that TELRIC permits assuming that a hypothetical future network would no longer require certain tasks, such as loop conditioning, that unquestionably have to be

performed in the real world and found that the CLEC must “bear the cost of compensating the incumbent LEC” for “modification of incumbent LEC facilities, such as loop conditioning.”<sup>31/</sup>

Notwithstanding this Commission requirement, there is no dispute that AT&T/WorldCom’s model “does not include certain types of costs”<sup>32/</sup> and therefore creates a subsidy for CLECs. First, as noted above, the model improperly assumes that most non-recurring costs should be recovered through recurring rates. That alone is reason to reject the *Order*’s decision to adopt AT&T/WorldCom’s model.

Second, the AT&T/WorldCom model does not even produce rates for a number of activities that even the Bureau agreed should be recovered on a non-recurring basis. Rather than relying on Verizon VA’s model for those non-recurring tasks — as the “baseball arbitration” rules require — the *Order* invites AT&T/WorldCom now to add those activities to its model. See *Order* ¶¶ 618, 639, 642, 648. But that will require AT&T/WorldCom to introduce new evidence concerning its experts’ assessment of the frequency with and time in which these non-recurring tasks might be performed in the forward-looking network, and the resulting non-recurring rates. The *Order* provides no opportunity for Verizon VA to engage in discovery concerning this new evidence, cross-examine the relevant witnesses, or otherwise subject it to appropriate challenge.

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<sup>31/</sup> *Local Competition Order* at 15692 ¶ 382; Third Report and Order and Fourth Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 3696, 3784 ¶ 193 (1999); Reply Brief for Petitioners Federal Communications Commission and the United States, *Verizon Communications, Inc., et al. v. Federal Communications Commission et al.* at 10 n.7 (July 2001) (“FCC Reply Brief”) (“[T]he [] suggestion . . . that TELRIC authorizes regulators to require incumbents to modify, ‘for free,’ loops to facilitate certain advanced services ignores express FCC directions to the contrary.”) (citations omitted).

<sup>32/</sup> *Order* ¶ 569; see also Verizon Virginia Inc. Non-Recurring Cost Panel Rebuttal Testimony at 8, 13-14, 25-26, 38, 42, 45 (Aug. 27, 2001) (“VZ-VA Ex. 116”); Verizon Virginia Inc. Non-Recurring Cost Panel Surrebuttal Testimony at 13-15 (Sept. 21, 2001) (“VZ-VA Ex. 124”).

Third, even the rates the AT&T/WorldCom model purports to produce are based on extreme hypothetical assumptions that are contrary to Commission rules. The *Order* itself describes the AT&T/WorldCom model as “interpreting ‘currently available’ as any technology that is *theoretically feasible*, even if it has not actually been implemented by any carrier.” *Order* ¶ 568 (emphasis added). As discussed above, this focus on mere “technical feasibility” violates the clear meaning of the Commission’s rule: the Commission has expressly held that simply because a technology might be “theoretically feasible” at some future time does not mean it is currently available by incumbents for use in providing UNEs. *See supra* at 20-21. AT&T/WorldCom’s entire model is premised on such “theoretically feasible” OSS and other technologies that allegedly would allow most tasks to be performed in an automated fashion. Yet the unequivocal record evidence demonstrated that such technology is not “currently available” and does not, for example, permit an incumbent to process orders automatically with only 2% fallout. VZ-VA Ex. 116 at 13-22. Ultimately, as the *Order* concedes, AT&T/Worldcom’s model is based “*solely* on the subjective opinion of its subject matter experts.” *Order* ¶¶ 571-72 (emphasis added). That is not a sufficient basis on which to set non-recurring costs.

In contrast, Verizon VA’s non-recurring model simply calculates the costs it will actually incur for a given task based on empirical data and would compensate Verizon for the costs it incurs as the Commission’s prior orders require. Verizon conducted an extensive survey of its workers with real-world experience to determine how long a particular task currently takes and the frequency with which it is performed. The survey results were validated by a statistician, and then subject matter experts made forward-looking adjustments to the resulting time and frequencies where currently available technologies would enable those tasks to be performed more efficiently. *See Verizon Virginia Inc. Recurring Cost Panel Direct Testimony* at 311, 316-317 (July 31, 2001)

(“VZ-VA Ex. 107”). In the case of order processing tasks, these times were validated by an independent third-party, Andersen Consulting. *See id.* at 313-14. Moreover, an outside consultant then reviewed the statistical precision of Verizon VA’s non-recurring cost estimates and calculated that, for all but a few UNEs, there was a 95% probability that Verizon’s non-recurring cost estimates reasonably estimated the cost Verizon VA will incur to perform the relevant task. *See id.* at 325. Thus, as even the *Order* concedes, Verizon VA provides “more support” for its time and frequency estimates than does AT&T/WorldCom. *Order* ¶¶ 571-72 (emphasis added).

Numerous states, including New York, have validated this methodology and relied on Verizon’s model to set non-recurring rates.<sup>33/</sup> Indeed, Verizon’s non-recurring cost model is the product of an extensive review by the New York commission. Ultimately, the ALJ in New York adopted all of Verizon’s work times and concluded that the statistical analysis of time estimates

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<sup>33</sup> Recommended Decision on Phase 3 Issues, *Joint Complaint of AT&T Communications of New York, Inc., MCI Telecommunications Corp., WorldCom, Inc. d/b/a/ LDDS WorldCom and the Empire Assoc. of Long Distance Tel. Cos., Inc. Against New York Tel. Co. Concerning Wholesale Provisioning of Local Exchange Serv. by New York Tel. Co. and Sections of New York Tel.’s Tariff No. 900*, Case 95-C-0657, 85-86 (Oct. 2, 1998) (“*Recommended Decision*”), affirmed by Order, *Re AT&T Comm. Of New York*, Case No. 95-C-0657, New York P.S.C., 15-16 (Feb. 22, 1999); *see also* Order No. 78552, *In the Matter of the Investigation Into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, Case No. 8879, Public Service Commission of Maryland, 87-88 (June 20, 2003) (“*Maryland UNE Order*”); Decision and Order, *In the Matter of the Board’s Review of Unbundled Network Element Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Docket No. TO-00060356, NJ B.P.U., 157-67 (Mar. 6, 2002) (“*New Jersey UNE Order*”); Order, *Investigation by the Department of Telecommunications and Energy on Its Own Motion into the Appropriate Pricing, Based Upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts Resale Services in the Commonwealth of Massachusetts*, Docket No. D.T.E. 01-20, MA Dep’t of Telecommunications and Energy, 432-500 (July 11, 2002) (“*Massachusetts UNE Order*”); Findings, Opinion and Order No. 5967, *Application of Verizon Delaware, Inc. (F/K/A Bell Atlantic-Delaware, Inc.), for Approval of Its Statement of Terms and Conditions Under § 252(f) of the Telecommunications Act of 1996*, Docket No. 96-324 Phase II, DE P.S.C., 31-35 (June 4, 2002) (“*Delaware UNE Order*”); Report and Order, *Review of Bell Atlantic-Rhode Island TELRIC Study*, Docket No. 2681, RI P.U.C., 62-69 (Nov. 18, 2001) (“*Rhode Island UNE Order*”).

resolved “any concerns about the statistical validity of the study.” *Id.* at 188. The New York commission adopted the ALJ’s recommendations. *Phase 3 Recommended Decision* at 141. Like the New York commission, this Commission itself has approved rates generated by Verizon’s non-recurring model as TELRIC-compliant in the context of 271 applications.<sup>34/</sup>

**C. The Order Should Be Stayed Pending Commission Evaluation Of Its Confiscatory Effect.**

The Commission also is legally obligated to stay the *Order’s* UNE rates in order to evaluate whether those rates would result in confiscation. Both the Act and the Constitution require the Commission to provide for recovery of both Verizon VA’s unrecovered historical costs and its actual forward-looking costs. The Bureau did not consider whether the UNE rates it adopted would enable Verizon VA to recover these costs. Accordingly, the Commission is obligated to evaluate whether application of the *Order’s* TELRIC rates produces a confiscatory outcome and may not allow those rates to go into effect before it has completed that inquiry. A stay is required pending the Commission’s completion of that process.

The Supreme Court has expressly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that specific rates are set, and the Commission

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<sup>34/</sup> See *Delaware/New Hampshire 271 Order* at 18711 ¶ 86; see also Memorandum Opinion and Order, *Application of Verizon Pennsylvania Inc., Verizon Long Distance, Verizon Enterprise Solutions, Verizon Global Networks Inc., and Verizon Select Services Inc. for Authorization To Provide In-Region, InterLATA Services in Pennsylvania*, 16 FCC Rcd 17419, 17458-59 ¶ 67 (2001) (“*Pennsylvania 271 Order*”); *Maryland/Washington, D.C./West Virginia 271 Order* ¶¶ 44, 55, 80-83; Memorandum Opinion and Order, *Application of Verizon New England Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions) And Verizon Global Networks Inc., For Authorization to Provide In-Region, InterLATA Services in Massachusetts*, 16 FCC Rcd 8988, 8998-99 (2001) (“*Massachusetts 271 Order*”).



itself has invited incumbents to provide precisely such information.<sup>35/</sup> Indeed, the law is clear that the Commission must consider this evidence and establish such a mechanism simultaneously with the setting of the rates themselves.<sup>36/</sup> In *Verizon Communications*, the Supreme Court concluded that it was premature to consider the ILECs' contention that TELRIC would produce a confiscatory result, because they did not challenge "particular, actual TELRIC rate[s]" and therefore it was uncertain whether TELRIC rates would enable incumbents to recover their past prudent investment or actual forward-looking costs. 535 U.S. at 524-28. The Court made clear, however, that once a state has determined specific UNE rates, those rates are subject to challenge on the basis that they fail to provide adequate compensation. *Id.* at 524. The Court further observed that the Commission had committed to considering "a challenge to TELRIC *in advance of a rate order*," provided that the challenge specifically showed how "a confiscatory rate is bound to result." *Id.* at 528 n.39 (emphasis added).<sup>37/</sup>

Accordingly, *before* permitting the rates produced by the *Order* to go into effect, the Commission must evaluate Verizon VA's contention that those rates would produce a confiscatory result. Although the Supreme Court upheld the Commission's decision not to include past prudent

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<sup>35/</sup> See *Verizon Communications*, 535 U.S. at 524 (stating that UNE rates are subject to challenge as a taking at the time they are set); *Local Competition Order* at 15872 ¶ 739 (recognizing that incumbents have a right to petition the Commission if TELRIC rates fail to provide sufficient compensation).

<sup>36/</sup> See, e.g., *Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1176-1179 (D.C. Cir. 1987) (where regulated entity presents serious allegations that rates may result in a taking, the agency *must* consider those allegations and look at the relevant evidence; failure to do so is reversible error); *Preseault v. ICC*, 494 U.S. 1, 11 (1990) (Constitution requires "reasonable, certain, and adequate provision for obtaining compensation at the time of the taking").

<sup>37/</sup> The Due Process Clause of the Fifth Amendment also requires that a utility be afforded a meaningful opportunity to challenge rates as confiscatory. See, e.g., *Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 593 (6th Cir. 2001); *Guaranty Nat'l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989).

investment as part of the *methodology* for determining UNE rates, the Court did not relax the bedrock requirement of the Act and the Constitution to consider incumbents' claims that the *outcome* of that methodology is a confiscatory rate.

Under sections 251(c)(3) and 252(d)(1), UNE rates must be “just and reasonable” — a standard that has long been interpreted to require rates that are *compensatory within the meaning* of the Fifth Amendment. *See, e.g., In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm’n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). In other words, the Act does not authorize the establishment of a confiscatory rate for UNEs. *See Verizon Communications*, 535 U.S. at 489 (Act permits “novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, *short of confiscating the incumbents’ property*” (emphasis added)).

The standard for determining whether UNE rates have a confiscatory effect is whether they permit the incumbent to recover its unrecovered historical costs and its actual forward-looking costs.

For nearly a century, the courts have evaluated claims that rates are confiscatory by determining whether they permit the utility *to recover its investment*, along with a return. *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591, 601-04 (1944); *see also Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm’n*, 262 U.S. 276, 290 (1923) (Brandeis, J., joined by Holmes, J., concurring). Thus, in *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court considered whether a slight modification of a historical cost ratemaking methodology would produce a confiscatory result by determining whether the shift adversely affected investors’ opportunity to recover all their previous prudent investment and an appropriate rate of return under the old methodology. The Court determined that the new method was still projected to produce

recovery that was “within the constitutional range of reasonableness” *as measured under the old methodology*. *Id.* at 312. Under *Duquesne*, in other words, the new system must still provide for recovery of the investments made under the prior system *and* a return on that investment that would have been constitutionally sufficient under the old system. Indeed, in their concurrence, Justice Scalia, joined by Justices White and O’Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate “fair return,” “all prudently incurred investment may well have to be counted.” *Id.* at 527 n.37.<sup>38/</sup>

In addition to unrecovered historical costs, a rate must also cover the actual forward-looking operating costs that the regulated entity will incur going forward. Thus, when the government compels the ongoing production of a good or service by a private party, the compensation provided must, at a minimum, cover the unavoidable costs of producing the good or service it has requisitioned and not force the entity to operate at a loss. In the case of UNEs, the incumbent is compelled to offer, maintain, and operate a portion of an *existing* network for the benefit of a third party. The ongoing capital costs and operational expenses of using that network in order to comply with this governmental mandate are unavoidable — they must be incurred in

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<sup>38/</sup> Likewise, the Commission itself has repeatedly recognized that incumbents are entitled to recover their unrecovered historical costs and stated its intention to provide such compensation. In the *Local Competition Order*, the Commission pledged that ILECs may “seek relief from the Commission’s pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates” and stated that it intended to consider in its Access Reform Proceeding the creation of “a mechanism separate from rates for interconnection and unbundled network elements” to provide recovery of ILECs’ historical costs. *Local Competition Order* at 15872 ¶ 739; *Access Reform NPRM* at 21360-61 ¶ 7. In its *Universal Service Order*, the Commission again promised that it would address “legacy costs” in its Access Reform Proceeding. Report and Order, *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, 8901-02 ¶ 230 n.593 (1997).

order to offer the required facilities and services on an ongoing basis. These are costs that the government is not constitutionally free to ignore.<sup>39/</sup>

The Commission, therefore, now has the duty to compare the *Order's* UNE rates to Verizon VA's past prudent investment and the actual forward-looking costs that Verizon VA can achieve in order to determine if the rates are confiscatory. The Commission cannot allow the *Order's* UNE rates to be made effective until and unless the Commission completes this evaluation. The Commission cannot defer its evaluation of Verizon VA's confiscation claim; it must ensure that Verizon VA is fully compensated within the meaning of the Constitution and the Act before it allows the *Order's* UNE rates to go into effect.<sup>40/</sup> This requires the Commission (a) to define the legal standard for determining whether the UNE rates have a confiscatory effect, and (b) to evaluate the evidence to determine whether the *Order's* UNE rates are confiscatory under this standard. Because the Commission lacks authority to adopt UNE rates until it has completed this analysis, it must stay the *Order's* UNE rates pending the Commission's further consideration and determination of whether the *Order's* rates would provide adequate compensation.

And it is clear that the rates do not meet this test. As the Commission Staff has now concluded, even TELRIC-compliant rates do not provide appropriate cost recovery. As its policy paper concludes, "if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents

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<sup>39/</sup> *United States v. Pewee Coal Co.*, 341 U.S. 114, 117-18 (1951) (plurality opinion) ("When a private business is possessed and operated for public use, no reason appears to justify imposition of losses sustained on the person from whom the property was seized."); *United States v. General Motors*, 323 U.S. 373, 379-83 (1945) (holding that when property is occupied by government mandate, the owner is entitled to recover his actual costs based on his particular circumstances).

<sup>40/</sup> See *supra* n.36.

to recover the cost of their investment.”<sup>41/</sup> That shortfall is of course exacerbated by the *Order*’s radical interpretation of TELRIC here. Indeed, the rates resulting from the *Order* will permit Verizon VA to recover neither its unrecovered historical costs nor its actual forward-looking costs. For example, the UNE-P rates produced by the *Order* are less than half the unrecovered historical cost of providing the UNE-P. *See Garzillo Decl.* ¶ 29. And those rates likewise are well below Verizon VA’s *actual* forward-looking costs. *See id.* ¶ 31.

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The net effect of the *Order*’s decisions is to drastically reduce rates that were already TELRIC-compliant, and to create new and increased subsidies for CLECs that rely on UNEs. The *Order*’s errors were compounded by the Bureau’s refusal even to consider directly relevant evidence that Verizon VA sought to introduce almost a year before the *Order* was issued — evidence that would have showed that many of the assumptions on which the Bureau’s *Order* is based are outdated and unsupportable. *See Verizon Virginia Inc.’s Motion to Permit Parties to Supplement the Record* (Nov. 22, 2002); *Verizon Virginia Inc.’s Proffer of Supplemental Evidence* (April 15, 2003). For example, Verizon VA’s proffer included evidence on the appropriate adjustments to reflect both the risks inherent in a competitive market and the added unique risks associated with competitors’ use of unbundled elements to provide service — risks that the Commission has clarified must be reflected in the cost of capital. Similarly, Verizon VA’s

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<sup>41/</sup> David M. Mandy & William W. Sharkey, *Dynamic Pricing and Investment from Static Proxy Models*, OSP Working Paper at 1 (Sept. 2003); *see also id.* at 1-2 (“Indeed, when investment costs are falling over time and TELRIC price reviews are conducted at intervals shorter than expected asset lives, the firm will earn less than its target rate of return under traditional implementations of TELRIC.”); *id.* at 43 (“When investment costs are falling by 11% per year (as is assumed for switching assets in the FCC Synthesis Model), the TELRIC correction factor is approximately 50%. That is, switching prices should be increased by 50% from those suggested by Synthesis Model runs.” (emphasis added)).

proffer included evidence showing that its experience since the initial cost studies submitted in this case demonstrates that wholesale uncollectible rates are substantially higher than the proxy (based on traditional access and similar services) used in its studies. *The Order's* failure to consider this and other evidence further understates rates.

**II. The Balance Of Equities Weighs Decisively In Favor Of A Stay Because The Order Would Cause Irreparable Harm And Is Contrary To The Public Interest With No Countervailing Harm to CLECs.**

If a stay is not granted, the public interest generally, and Verizon VA in particular, will suffer certain and immediate irreparable injuries. In contrast, the CLECs will suffer no harm if the *Order* is stayed pending review. In such circumstances, a stay is warranted.<sup>42/</sup>

As numerous investment analysts have recognized, Verizon VA is already incurring substantial financial losses due to the purely synthetic competition created by the availability of UNE-P at TELRIC rates. For example, the May 1, 2002 quarterly report from Commerce Capital Markets concluded that “[f]or all RBOCs, UNEs are priced below cash operating cost, and radically below total operating cost including depreciation and amortization. The discounts from total cost are 50%-60% below total cost even when total cost does not include cost of equity, a component that is allowed under TELRIC.”<sup>43/</sup>

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<sup>42/</sup> See, e.g., *FTC v. Libbey, Inc.*, 211 F. Supp. 2d 34, 54-55 (D.D.C. 2002) (“In light of . . . the possible inability to provide meaningful and complete relief to [the party] if it is ultimately successful . . . , the weighing of the equities in this matter tips the scales in favor of [that party].”); Memorandum Opinion and Order, *AT&T Corp., et al., v. Ameritech Corp.*, 13 FCC Rcd 14508, 14521 ¶ 27 (1998).

<sup>43/</sup> A. Kovacs et al. Commerce Capital Markets, Inc., *The Status of 271 and UNE-Platform in the Regional Bells' Territories* at 15 (May 1, 2002) (emphasis added); *id.* (“[R]egulators are forcing RBOCs to wholesale their network at rates that are significantly below the costs that the financial community looks at.”); M. Crossman et al, J.P. Morgan Securities, Inc., *Industry Update – No Growth Expected for Bells in 2003* at 15 (July 12, 2002) (“For all RBOCs, UNEs are priced below cash operating cost, and radically below total operating cost including depreciation and